No.___

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1993

MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD., GEOFFREY TOWNSEND, LTD., BARRISTER ASSOCIATES, PARLIAMENT SECURITIES CORP., PAUL BELLOFF AND ROBERT GOLD,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the United States Court of Appeals for the Second Circuit erred when it held, as a matter of law, that arm's length bargaining does not exist when a party to a transaction considers favorable tax consequences, as well as other business considerations, on entering into a transaction.

2. Whether an investment promoter may be found liable for a penalty under I.R.C. Section 6700 for gross valuation overstatements based on *post hoc*, subjective appraisal evidence, despite uncontradicted testimony that the allegedly overvalued properties were purchased in arm's length transactions between unrelated parties.

PARTIES TO THE PROCEEDING

All the parties to the proceeding in the United States Court of Appeals for the Second Circuit were Madison Library, Inc., Universal Publishing Resources, Ltd., Geoffrey Townsend, Ltd., Barrister Associates, Paul Belloff, Parliament Securities Corp. and Robert Gold. All of those parties are interested in this proceeding.[1]

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[1]Petitioner Universal Publishing Resources, Ltd. is a wholly-owned subsidiary of Petitioner Geoffrey Townsend, Ltd., which is a wholly-owned subsidiary of Petitioner Madison Library, Inc. Petitioner Madison Library, Inc. is a wholly-owned subsidiary of Hamilton Management Corp., a closely held corporation with no corporate parents. Petitioner Parliament Securities Corp. is a closely-held corporation with no corporate parents or subsidiaries.

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MADISON LIBRARY, INC., UNIVERSAL PUBLISHING RESOURCES, LTD., GEOFFREY TOWNSEND, LTD., BARRISTER ASSOCIATES, PARLIAMENT SECURITIES CORP., PAUL BELLOFF AND ROBERT GOLD,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI

Petitioners Madison Library, Inc. ("Madison"), Universal Publishing Resources, Ltd. ("Universal") and Geoffrey Townsend, Ltd. ("Townsend"), Barrister Associates ("Barrister"), Parliament Securities Corp. ("Parliament"), Paul Belloff and Robert Gold (collectively "Petitioners"), respectfully request that a writ of certiorari be issued to review a decision of the United States Court of Appeals for the Second Circuit, entered on March 22, 1993. That decision affirmed the judgment of the United States District Court for the Eastern District of New York, entered following a trial by jury finding Petitioners liable to pay a penalty pursuant to I.R.C. Section 6700.

OPINIONS BELOW

A copy of the opinion of the United States Court of Appeals for the Second Circuit, entered on March 22, 1993, and reported at 989 F.2d 1290 (2d Cir. 1993), is annexed hereto as an appendix. Also annexed as an appendix is a copy of the Mandate issued June 7, 1993. A copy of the

order of the United States Court of Appeals for the Second Circuit, dated May 20, 1993, which denied Petitioners' petition for a rehearing and suggestion for rehearing in banc is also annexed as an appendix. Also annexed as an appendix is the judgment of the district court, entered after a jury trial, on June 10, 1991. Also annexed as an appendix are the orders of the United States District Court, Eastern District of New York, dated September 19, 1991 and September 30, 1991, denying Petitioners' motions for judgment notwithstanding the verdict or a new trial.

JURISDICTION

The decision of the United States Court of Appeals for the Second Circuit, of which review is sought, was entered on March 22, 1993. That decision affirmed the decision of the United States District Court for the Eastern District of New York, entered following a trial by jury, which found Petitioners liable to pay a penalty pursuant to I.R.C. Section 6700. A petition for rehearing and suggestion for rehearing in banc was denied on May 20, 1993. Jurisdiction to review the judgment in question by certiorari is conferred by 28 U.S.C. Section 1254(1).

STATUTORY PROVISIONS INVOLVED

Title 26 U.S.C. Section 38(a); Title 26 U.S.C. Section 46(a)(2)(A); Title 26 U.S.C. Section 46(c)(1); Title 26 U.S.C. Section 48(a)(1)(A); Title 26 U.S.C. Section 48(d); Title 26 U.S.C. Section 465(b)(2); Title 26 U.S.C. Section 1012; Title 26 U.S.C. Section 6700; Title 26 U.S.C. Section 6703; Rules 401 and 702 of the Federal Rules of Evidence.

STATEMENT OF THE CASE

A. INTRODUCTION.

In 1982 and 1983, Petitioners Townsend and Universal, respectively, purchased certain properties, including films, plates and other materials (the "Properties") used in the manufacture of books and computer software (the "Works"). All of the Properties were purchased from unrelated publishers in arm's length transactions. At the time of the purchases by Townsend and Universal, the Works had already been scheduled for publication and distribution by the publishers in the normal course of business in the hopes of generating profits; thus, the Works would have been published whether or not Universal or Townsend purchased them.

Townsend or Universal purchased each Property for a price represented by a small cash down payment and a twelve-year promissory obligation. The promissory obligation (frequently referred to at trial as a "note," although there was no separate promissory note) bore simple interest at nine per cent per annum. The obligation to amortize the debt before the end of the term depended on the sales of each Work; after twelve years a balloon payment was required for any remaining unpaid sums. As books sold, the publisher received all or most of Townsend's or Universal's proceeds of sale on the initial printing, and a somewhat smaller percentage of their proceeds thereafter, until all principal and interest were paid. The promissory obligation was recourse to Townsend or Universal, and was secured by a chattel mortgage on the Property.

The Properties purchased by Universal and Townsend were leased, in groups of approximately forty, to a number of limited partnerships (the "Partnerships"). Petitioner Barrister, a general partnership, was the general partner of all but two of the Partnerships; Barrister's partners, in turn, were Petitioners Paul Belloff and Robert Gold. The leases with the Partnerships were for eight-year terms. The Partnerships' rent payments had a "fixed" component and a "variable" component based on the number of copies of the Work sold. The Partnerships engaged affiliates of the selling publishers to print, bind, distribute and promote the Works. They were required by contract to use their best efforts to obtain as wide a distribution as possible and to furnish an annual marketing plan for the Works. Their fees were based solely upon the number of copies of each Work sold.

During 1982 and 1983, when Townsend and Universal negotiated the purchases of the Properties, the Internal Revenue Code allowed a tax credit for acquisition of certain types of tangible property, such as the Properties at issue here. I.R.C. Sections 38(a), 46(a)(2)(A), 46(c)(1), 48(a)(1)(A). The amount of the credit was based on the cost of the property. I.R.C. Sections 46(c)(1), 1012. Universal and Townsend, pursuant to Section 48(d) of the Internal Revenue Code, elected to pass through to the Partnerships the investment tax credits that would have been available on the purchase of the Properties.

In June 1986 the Internal Revenue Service ("I.R.S.") assessed penalties against the Petitioners and others pursuant to I.R.C. Section 6700. Petitioners paid fifteen percent of the penalties asserted, staying further collection action, I.R.C. Section 6703(c)(1), and commenced

actions for refunds of the amounts paid.[2] Although Petitioners were technically the plaintiffs in this action, the government had the burden of proof. I.R.C. Section 6703(a). In the Second Circuit, the standard of proof is clear and convincing evidence. *United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 785 (2d Cir. 1986), *aff'g*, 601 F. Supp. 1554, 1567 (S.D.N.Y. 1985).

At trial, the government attempted to prove that Petitioners were liable for a penalty under I.R.C. Section 6700 of the Internal Revenue Code of 1954 for making gross valuation overstatements with regard to the Properties.[3] The statute defines "gross valuation overstatement" as a statement as to the value of property or services if:

> (A) The value so stated exceeds 200 percent of the amount determined to be the correct valuation, and
>
> (B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 [of the Code] to any participant.

Section 6700(b)(1).

Petitioners contended at trial that there was no valuation overstatement because the Properties were purchased in arm's length transactions between voluntary, knowledgable buyers and sellers, fixing the Properties' purchase prices as their fair market values. *See United States v. Cartwright*, 411 U.S. 546, 533 (1973). Introducing no evidence

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[2]Petitioners Barrister, Parliament, Paul Belloff, and Robert Gold filed suit in the United States District Court for the Eastern District of New York. Petitioners Madison, Townsend and Universal commenced actions in the United States District Court for the District of Nevada, where they were incorporated. The Nevada actions were transferred to the Eastern District of New York by the Judicial Panel on Multidistrict Litigation, and were later consolidated for trial in the Eastern District of New York.

[3]The government also sought to prove that in violation of Section 6700, the Petitioners issued false or fraudulent statements with respect to the tax benefits to be realized by those who purchased an interest in one of the partnerships. The jury so found. This jury finding was challenged on appeal. In affirming the district court decision, the Second Circuit Court of Appeals affirmed the finding of gross valuation overstatements and, as such, did not reach the jury's finding regarding false or fraudulent statements. Whether the jury properly found that there were false or fraudulent statements, therefore, is not at issue in this Petition.

of collusion between the buyer and seller, and relying instead on *post hoc* appraisals grounded in the appraisers' subjective views of the Works, the government contended that those prices were intentionally inflated without regard to business considerations to increase basis for tax purposes. This dispute is at the heart of this proceeding.

B. EVIDENCE OF THE NEGOTIATIONS INTRODUCED AT TRIAL.[4]

1. The Evidence Introduced by the Petitioners.

At trial, Petitioners introduced evidence that the purchase prices for the Properties were negotiated in arm's length bargaining between unrelated parties, with both sides seeking their best economic advantage.

Some publishers, such as Citadel and Stewart Tabori & Chang, furnished Townsend and Universal with titles, synopses, information on the authors, initial print numbers, cover price, and estimates of additional printings. The price of each property was then separately negotiated, usually between Irving Cohen, then the president of Townsend and Universal, and a principal of the publisher. (A98-102.) However, for some publishers with whom Mr. Cohen had previously done business and from whom many Properties were purchased, formulas were negotiated from which the purchase prices were derived.

Richard Gallen, for example, who represented his own company and a number of other publishers in these negotiations (A76-77), testified at trial that the purchase prices were the "product of negotiations that had taken place before any single book was purchased. . .." (A81.) Mr. Gallen negotiated purchase prices that provided the publisher the equivalent of almost all of the revenues from the first printing, after deducting the national distributers' fees, and sixty percent of such revenues for the next seven printings. For each Property, the publisher would furnish Mr. Cohen with the number of books that would be printed initially and the cover price of each book. From these two figures, Mr. Cohen or his delegate would compute purchase prices based on the negotiated formula. (A91-95.) Mr. Cohen would then make an offer commensurate with that calculation, or, at times, would attempt to negotiate a somewhat lower number. (A95.)

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[4]The portions of the trial testimony and trial exhibits cited herein are attached to this Petition as appendices H & I. Citations to particular pages of the appendicies are made thus: (A____).

Mr. Gallen testified that his negotiations with Mr. Cohen were conducted at arm's length, and that Mr. Cohen "vigorously" sought the best possible economic deal for his side. (A78-80.) After Mr. Cohen had negotiated a more favorable purchase price formula with another publisher, he asked Mr. Gallen to renegotiate. Mr. Gallen refused. (A97.)

Price, Stern and Sloan, publisher of juvenile and activity books, inititally demanded a price equivalent to an income stream from twenty printings. Mr. Cohen negotiated the figure down to twelve printings. (A83-84.) There were "tooth and nail" negotiations between Mr. Cohen and Price, Stern and Sloan. (A107.)

Negotiations with Walter Zacharius, president of Kensington Publishing, were particularly contentious; on the terms and conditions offered, Mr. Zacharius refused to accept lower prices. (A82.)

Before the purchases were consummated, Universal, Townsend and the Partherships retained experts such as James Bryans, publisher of *To Kill a Mockingbird*, to evaluate the reasonableness of the purchase prices. (A111.) When an expert thought that the price for a particular Property was too high, Mr. Cohen renegotiated or declined to purchase the Property. (A88.)

In negotiating each of the purchases, Mr. Cohen sought to acquire as many Properties for as little cost as possible because he believed that ownership of more Properties for the same cost would increase the likelihood of profits. (A96.) Additionally, the smaller the initial cash outlay required, the more Properties Townsend and Universal could afford to acquire. (A89-90;96.) Mr. Cohen also believed that the publishers' affiliates were more likely to fulfill their obligations to promote the Works vigorously if they received less cash up front and would receive additional payments, over the near term, solely upon successful sales. (A106.) As such, in negotiating each purchase, Mr. Cohen employed recourse debt, represented by a small cash down payment and a twelve-year promissory obligation. (A91-93;103.) Asked at trial for his incentive for keeping the notes and purchase prices low, Mr. Cohen testified: "I tried to buy twice as many of these very same books for the same amount of money and was turned down." The same tax credit would have been available had he done so, "[a]nd it would have been easier to pay off the notes . . .." (A87.)

2. The Evidence Introduced by the Government.

At trial, the government did not introduce any direct evidence about the negotiations themselves. It offered no evidence of collusion, or of any secret agreements that would affect the validity of the transactions or the debt instruments. Instead, the government introduced *post hoc* subjective appraisal evidence through four appraisers. Works from six "test" Partnerships[5] were divided among these appraisers. These government appraisers read the Works, gave personal opinions about their quality and subject matter, and opined as to the number of copies of each Work they believed would sell. These appraisers' sales estimates were so low that the publishers, who had invested substantial sums in the Properties before bringing a single book to market, would not have made a profit. (A104-05.)

The government's appraisers did not pretend that their method was objective. A few examples from testimony and 273 written appraisals illustrates the subjective nature of their evaluations.

One government appraiser, Thomas Congdon, acknowledged that "[r]easonable people might differ" with his projections (A75) and agreed that "the publishing business is like drilling for oil, you lose a lot of times and sometimes you hit it." (A73-74.) Mr. Congdon admitted that his publishing decisions are made based on whether he has a "tingle" about a book. (A74.) He testified that he once purchased a book because he had "the real zap," but conceded that this purported methodology "doesn't always work." (*Id.*) Of Nicholas Proffit's *Garden's of Stone*, one of the Works at issue, Mr. Congdon testified: "I wouldn't have a zap on that book. It was a sort of dull thud for me." (A74.)

Gloria Mosesson, who appraised 199 of the 273 Works appraised by the government, explicitly declined to say the sales figures were "objectively arrived at." (A71-72.) She testified that she based her sales figures on "me as a consumer and on me as a publisher," and that she arrived at her sales estimates "by having vibes of what was going on. . .." (A65-66, 70.)

Ms. Mosesson appraised a novel by Samuel Beckett entitled *Worstword Ho!* She criticized the work because its cover was not, in her judgment, sufficiently colorful, and she regarded the book as a "joke."

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[5]The parties stipulated that evidence as to the Properties' values would be presented as to only six Partnerships and that the jury's findings as to these Properties would apply to all the Properties in the other Partnerships.

(A57-59, 62-63.) Although Universal purchased the Property for $325,000, Ms. Mosesson judged the book to be worth $3,291. (A59-60.) Discussing *The Flying Devis of Dunhuang*, an art book purchased by Universal, Ms. Mosesson, in describing Chinese paintings it portrayed, commented, "if you have seen one, you see them all." (A56.) She acknowledged that whether a person finds such paintings interesting "[is] a very subjective thing." She did not find them interesting. (A61.)

Ms. Mosesson said the art work for the cover of the book *All the Love Poems of Shakespeare* was "not a smash. I don't think it is especially a pretty jacket cover." (A63-64.) Ms. Mosesson's written appraisal of *Windhaven's Destiny*, a mass-market paperback that was part of a best-selling series, states: "Although this series has apparently had sales success, it would seem that there is a limit to how much you can drag on the story of a family like this. . .. In addition, the book is not written well enough to make a reader want to wait for the next episode in the story of this family." (A116.) Citing no independent research, Ms. Mosesson went on to question the publisher's veracity in stating on the book jacket that nine million copies of the series had already been sold. (*Id.*)

Charles Seldon appraised the test Partnerships' computer software and books. Mr. Selden termed "odd" and "disgraceful" the educational software developed by Roger Schank, Chair of Yale University's Computer Science Department, and gave the software a fair market value of $ 0. (A51.) He gave *The Personal Computer in Advertising*, a book featured in one of Banbury Books, Inc.'s promotional brochures, a fair market value of $ 0. (A126.) Mr. Seldon even gave a $ 0 value to two books chosen for distribution by Putnam, one of the country's major book distributors. (A53-54.) In fact, Mr. Selden assigned fair market values of $ 0 to twelve of the seventeen Works he appraised, suggesting, in essence, that their creators and publishers would have given them away in arm's length transactions. (A126.)

The fourth government appraiser, Edward Knappman, discussing *Classics of the Silent Screen*, a book by television personality Joe Franklin that had been in print since 1959, opined that the number of people who would be interested in this genre would be substantially diminished by 1983. He admitted that a subject like silent movies "has very little interest to me." (A45-49.)

THE VERDICT AND JUDGMENT

Petitioners moved for directed verdicts at the close of the government's case and at the close of the evidence. These motions were predicated on Petitioners' contention that the appraisal evidence produced by the government, which bore the burden of proof, was irrelevant and insufficient as a matter of law because there was uncontradicted evidence of arm's length bargaining. These motions were denied. Presented with the *post hoc*, subjective appraisal testimony that the Partnerships' Works were doomed to fail, the jury found that the Properties in the six test partnerships were overvalued. After briefing, the district court calculated the penalties for each Petitioner and entered judgment in the amounts of $400,000 for Madison, $4,395,925 for Townsend, $8,994,367 for Universal, $534,692.50 for Barrister, $1,446,712.50 for Parliament, $9,667.00 for Paul Belloff, and $9,667.00 for Robert Gold. Petitioners' motions for judgment not withstanding the verdict or a new trial were denied without opinion.

THE COURT OF APPEALS DECISION

Petitioners appealed to the United States Court of Appeals for the Second Circuit, challenging the trial court's denial of their motions for a directed verdict and for a judgment notwithstanding the verdict or a new trial. The Petitioners argued that the finding of gross overvaluation should be reversed because the Properties' values were established in arm's length bargaining and the government's *post hoc*, subjective appraisal evidence was irrelevant and inadmissible.

Notwithstanding the uncontradicted testimony that the transactions were conducted at arm's length and the absence of any evidence of collusion, the Second Circuit affirmed. In explaining its affirmance, the Second Circuit held that the jury could have concluded that the negotiations were not arm's length because tax factors were considered in structuring the transactions.

The Second Circuit also held that the trial court properly permitted the jury to consider the government's *post hoc* appraisal evidence in determining whether the transactions were at arm's length and further held that the government's appraisal evidence was not too subjective to be admissible.

REASONS FOR GRANTING THE WRIT

I. THE SECOND CIRCUIT OPINION, IN CONTRAVENTION OF THIS COURT'S ESTABLISHED AUTHORITY, IMPROPERLY HELD THAT BECAUSE FAVORABLE TAX CONSEQUENCES WERE CONSIDERED BY PETITIONERS DURING THE NEGOTIATIONS, THE NEGOTIATIONS WERE NOT ARM'S LENGTH.

The uncontradicted testimony at trial was that the purchase prices of the Properties, including the amount of cash down payment and debt, were negotiated in arm's length transactions between unrelated parties, with the adverse parties seeking their own best economic advantages. These negotiations established the Properties' fair market values. *See United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Abramson v. Commissioner*, 86 T.C. 360, 371-73 (1986). The entire cost of the Properties, including the recourse debt, was therefore properly taken into account in determining the amount of tax credit that could be passed through to the Partnerships. I.R.C. Section 46(c)(1), 1012. *See Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 96 (4th Cir. 1985); I.R.C. Section 465(b)(2) (recourse debt is considered "at risk" for the purposes of determining permissible extent of deductions or credits).

Petitioners did not dispute at trial and do not now dispute that the tax credits to be gained played a role in their decision to negotiate the purchases in this manner. However, the uncontradicted testimony at trial also established that there were business reasons for negotiating the purchases in this manner. The smaller the cash outlay, the more Properties Townsend and Universal could afford to purchase. In addition, the publishers were more likely to fulfill their obligations to promote the Works produced vigorously if they received less cash up front and would receive additional payments near term based solely upon successful sales. (*See supra p. 6*).

The Second Circuit was disturbed that favorable tax consequences were taken into account in structuring the transactions in this fashion. The court held that that fact was a sufficient basis for the jury to have found an absence of arm's length bargaining: "An arm's-length transaction between a buyer and seller is one untainted by motives other than the desire of each to obtain the best price." *In re MDL-731 -- Tax Refund Litigation*, 989 F.2d 1290, 1298 (2d Cir. 1993); (A1, 15). In this case, the opinion states, tax reduction was the impermissible other motive. *Id.* at 1298-99; (A15-16).

This Court has held, however, that there is nothing improper about taking favorable tax consequences, along with other business considerations, into account in deciding how to structure a business transaction. *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). "The fact that favorable tax consequences were taken into account on entering into a transaction is no reason for disallowing those consequences." *Id. See also Commissioner v. Wodehouse*, 337 U.S. 369, 410 (1949) ("The fact that the incidences of income taxation may have been taken into account by arranging matters one way rather than another so long as the way chosen was the way the law allows, does not make a transaction something else than it truly is – it does not turn a sale into a license") (Frankfurter, J., dissenting) (citation omitted); *Rosenfeld v. Commissioner*, 706 F.2d 1277, 1281 (2d Cir. 1983) ("Many financial decisions are motivated by the prospect of legitimate tax savings . . .. [A] transaction is not unlawful merely because an individual seeks to minimize the tax consequences of his activities"); *Brooke v. United States*, 468 F.2d 1155, 1158 (9th Cir. 1972) (where record reflected non-tax motives as well as tax savings motives were behind taxpayer's decision to transfer building to his children, deductions would not be disallowed); *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose a pattern which will best pay the Treasury") (Hand, J.), *aff'd*, 293 U.S. 465 (1935).

The Second Circuit's use of the term "best price" to define arm's length bargaining also appears to overthrow the established principle that current deductions and tax credits may be taken on a price payable over time, even if that price is higher than an all-cash price might have been. *Abramson v. Commissioner*, 86 T.C. 360, 371 (1986); *Sheid v. Commissioner*, 50 T.C.M. (CCH) 663 at n. 29 (1985). Prior to the Second Circuit's opinion, debt had not previously, in and of itself, been thought to "taint" otherwise arm's length bargaining.

By holding that consideration of tax consequences is sufficient grounds to disregard a negotiated purchase price and to overcome uncontradicted testimony that the bargaining was at arm's length, the opinion brands the great majority of business transactions as not arm's length. If the Second Circuit's opinion is allowed to stand, any leveraged transaction in which the interest deduction under I.R.C. Section 163 is taken into account, for example, will be fair game for the Internal Revenue Service.

It is respectfully submitted that the opinion is in contravention of this Court's established authority and certiorari should therefore be granted.

II. THE SECOND CIRCUIT'S APPROVAL OF THE ADMISSION OF POST HOC APPRAISAL EVIDENCE TO ESTABLISH THAT A BUSINESS TRANSACTION WAS NOT BONA FIDE PLACES IT IN CONFLICT WITH THE DISTRICT OF COLUMBIA CIRCUIT AND OTHER FEDERAL COURTS.

In order to establish that Townsend and Universal's negotiations with the publishers were not at arm's length and that the purchase prices for the Properties were inflated, the government introduced the testimony of expert witnesses who testified, eight years after the fact, as to what values *they* would have placed on the Properties at the time and what Properties they would have considered purchasing. These witnesses, stating their personal opinions, adjudged that virtually all of the prices paid by the Petitioners were inflated. Indeed, these witnesses testified that many of the Properties, in which the publishers had already invested substantial sums of money (*see supra pp.2-3*), had no market value at all. (*See supra p. 8*).

The Second Circuit opinion held that it was proper for the district court to permit the jury to consider these appraisers' *post hoc* business judgments in determining whether the negotiated prices were intentionally inflated. This holding places the Second Circuit in conflict with the United States Court of Appeals for the District of Columbia Circuit and other federal courts, and sets a dangerous precedent.

In *Cornfeld v. Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986), the United States Court of Appeals for the District of Columbia Circuit explicitly rejected the use of hindsight in tax cases as a basis for attacking the bona fides of a business transaction, and in particular, the prices paid by the taxpayer for a property.

In *Cornfeld*, the taxpayer purchased a passenger jet aircraft and pursuant to I.R.C. Section 183 sought business deductions attributable to the ownership of this aircraft. The I.R.S. challenged the business deductions by alleging that the prices paid for the purchase and modification of the aircraft were excessive and that these activities were not undertaken "for profit." *Id.* at 1051.

The Tax Court ruled for the I.R.S., in part because, in the Tax Court's judgment, the taxpayer's decision to expend substantial sums of money to remodel the aircraft could not have "'enhanced the prospect of profits.'" 797 F.2d at 1053 (quoting from Tax Court opinion).

The District of Columbia Circuit, in reversing the Tax Court, rejected the use of hindsight:

> We cannot approve such second-quessing of business judgments by the court. The question is not whether we, or the Tax Court judge, think a particular mode of doing business is wise, but whether the taxpayer honestly believed that the method he employed would turn a profit for him. . ..

Id. at 1053.

This sort of second-guessing is exactly what the Second Circuit approved in this case. The government's appraisers acknowledged that their appraisals were based on their own personal business judgments, judgments about which others might differ. Yet the Second Circuit permitted the factfinder to find a lack of bona fide arm's length bargaining based on those appraisers' judgments, *i.e.*, based on the appraisers' testimony that their business judgments differed from Petitioners' judgments. By permitting the jury to give the appraisers' hindsight judgments controlling weight, the Second Circuit placed itself squarely in conflict with the District of Columbia Circuit.

Other federal courts have also rejected the use of *post facto* business judgments in tax cases.

In *Wright v. United States*, 249 F. Supp. 508 (D. Nev. 1965) the court trenchantly rejected an attempt by the I.R.S. to use hindsight business judgments to challenge taxpayer business deductions. In *Wright*, the I.R.S. argued that the taxpayer, a farmer, was not entitled to deductions for business losses, because, in the I.R.S.'s judgment, the farmer should have abandoned the enterprise after it experienced operating losses for several years. The court, finding that there was uncontradicted evidence that the taxpayer embarked upon and operated the farming enterprise in good faith, rebuked the I.R.S. for its attempt to introduce *post hoc* business judgments:

> [E]ach taxpayer is entitled to conceive and embark upon his own business enterprise, no matter how impractical, idiosyncratic or questionable of success it may seem to others. . . It is not for the Collector to second-guess the taxpayer. . .[n]or it is it for the Collector to criticize the particulars of the management of the business. Such Monday morning quarterbacking is easy, but it should be acknowledged somewhere along the line that if the success of

> American business should be made to depend on the business acumen of the Collector of Internal Revenue rather than the enterprise, imagination, initiative and gambling instinct of the American businessman, little progress would be probable.

Id. at 249. *See also King v. United States*, 545 F.2d 700, 709 (10th Cir. 1976) ("We cannot, by hindsight, disallow a deduction simply because the [investment] did not prove to be profitable").

The Tax Court has also rejected the use of *post hoc* appraisal evidence where there has been no independent demonstration that there was an absence of arm's length bargaining. *Sheid v. Commissioner*, 50 T.C.M. (CCH) 663, 670 n. 24 (1985) ("Conceivably in some circumstances such testimony may help us to arrive at the conclusion that the purchase price represents fair market value, *but where that determination is made independently, appraisal evidence becomes immaterial.*") (emphasis added). *Accord Abramson v. Commissioner*, 86 T.C. 360, 372 & n. 16 (1986) (rejecting *post hoc* appraisal evidence as "immaterial" when the taxpayer had demonstrated that the purchase price was the result of arm's length, good faith bargaining).

Indeed, one eminent tax authority has stated that when, as here, an expert's valuation is made years after the transaction at issue and there is other evidence establishing market value, the expert's opinion has no probative value. "If the valuation is made several years after the basic date, the expert's opinion will be regarded as lacking in probative value, especially where there is other evidence showing a different value." 15 *Mertens Law of Federal Income Tax*, § 59.11 at 37 (1992).

Because such hindsight is not probative, it is not admissible under either Rules 702 or 401 of the Federal Rules of Evidence. *See* Rule 702 (permitting the admission of expert testimony only where it "will assist the trier of fact to understand the evidence or to determine a fact in issue. . ."); Rule 401 ("'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable than it would be without the evidence.")

The approach followed by *Cornfeld* and the other cited authorities is salutory. A litigant will always be able to find appraisers whose *post hoc* business judgments differ from the parties to those transactions. When speculative investments are involved, and particularly in an industry such as publishing, where publishers' judgments differ so widely, knowledgeable people will have very different judgments about the commercial potential of a venture. As such, the *post hoc* judgments even

of expert appraisers are not probative of whether, at the time of the transactions, the purchaser believed in good faith in the profit potential of the venture and bargained at arm's length.

Indeed, it is hard to see how any *post hoc* appraiser in an industry for which success depends on public acceptance could be unaffected by knowledge of whether the work under evaluation was a success. Knowledgeable people would know of a work if it was a commercial success; if they had not heard of it, the inference would be that it was not. For *post hoc* appraisers to place themselves in the position of a purchaser prior to the work's distribution is akin to efforts to unring a bell. As one court has succinctly stated: "Would an experienced financial analyst testify to a price valuation that subsequent events demonstrated was too high? How much probative force can be given a projection that is confidently put forth in the knowledge that subsequent events bore it out?" *Simon v. New Haven Board and Carton Company*, 393 F. Supp. 139, 145 (D. Conn. 1974), *aff'd*, 516 F.2d 303 (2d Cir. 1975).

This approach does not leave the government without a remedy. At trial, through the examination and cross-examination of the participants in and witnesses to the negotiations, as well as critical scrutiny of contemporaneous documentary evidence, the government may delineate for the jury the objective facts that were ascertainable at the time the transactions occurred and attempt to demonstrate therefrom that the negotiations were not arm's length and undertaken in good faith. *Cf. Bixby v. Commissioner*, 58 T.C. 757 (1972) (Tax Court disregarded a purchase price where there was a large step-up in price negotiated between related parties).

Because there was no independent demonstration that there was an absence of arm's length bargaining, Petitioners' motions for a directed verdict and for judgment notwithstanding the verdict should have been granted. Alternatively, if the issue was properly submitted to the jury, it should have gone with the instruction that the jury was not to consider the appraisal evidence unless it first determined that arm's length bargaining had not occurred, not with the vague instruction to give the evidence "such weight as *you may think it deserves*" (emphasis added). (A108.)

III. SUBJECTIVE APPRAISAL EVIDENCE IS IRRELEVANT AND INADMISSIBLE.

The government's appraisal evidence was also so highly subjective and, therefore, so irrelevant and prejudicial, that its submission to the jury violated Rules 401 and 702 of the Federal Rules of Evidence.

As noted, four government appraisal witnesses read the Works (one appraiser per Work) and offered their personal reactions to the Works' quality and subject matter. Based on these reactions, they estimated the likely sales volume of each Work and a projected a net income figure to a hypothetical publisher. Many of the appraisals resulted in fair market values of $ 0. The appraisers made no pretense that their appraisals were objective. One appraiser admitted that her estimates were based on her own views as a consumer and a publisher, were arrived at by having "vibes of what is going on. . .," and explicitly declined to say the estimates were "objectively arrived at." She regarded a Work by Samuel Beckett as a "joke," and commented that whether the subject matter of a book on Chinese art was interesting was "a very subjective thing." Another government appraiser conceded that he made sales projections based on whether his reaction to the Work was a "tingle," "zap," or "dull thud." The Second Circuit held that it was permissible for such highly subjective testimony to go to the jury.

In so holding, the Second Circuit placed itself in conflict with other federal circuits. Other circuit courts, pursuant to both Rules 401 and 702 of the Federal Rules of Evidence, have held subjective expert testimony inadmissible because such evidence is of little probative value and has the tendency to prejudice the jury. As the United States Court of Appeals for the Fifth Circuit has cogently held: "Without more than credentials and a subjective opinion, an expert's testimony that 'it is so' is not admissible." *Viterbo v. Dow Chemical Co.*, 826 F.2d 420, 424 (5th Cir. 1987). *See United States v. Whitted*, 1993 U.S. App. Lexis 11942 (8th Cir. May 24, 1993) (doctor's subjective testimony should have been held inadmissable under Rule 702 because in light of the witness's stature as an expert there was a danger that the jury overlooked the subjective nature of his testimony and "surrendered its own common sense. . ."); *Loudermill v. Dow Chemical Co.*, 863 F.2d 566, 570 (8th Cir. 1988) (expert testimony lacking objective factual support cannot help the jury and is inadmissible under Rule 702); *accord Marks v. Pan American World Airways, Inc.*, 785 F.2d 539, 542 (5th Cir. 1986) (under Rule 702 an award of damages "'cannot stand when the only evidence to support it is speculative or purely conjectural.'") (quoting *Haley v. Pan American World Airways,*

Inc., 746 F.2d 311, 316 (5th Cir. 1984)); *Johnson v. Serra*, 521 F.2d 1289, 1293 (8th Cir. 1975) (trial court abused its discretion in admitting expert testimony that was "too speculative and conjectural, thus lacking sufficient probative value to outweigh the danger that it would lead the jury to assess damages on an improper basis.") (citations omitted). Indeed, this was the rule in the Second Circuit prior to this case. *See Jacobson v. Commissioner*, 915 F.2d 832, 838-39 (2d Cir. 1990) (rejecting a "Siskel and Ebert 'thumbs up, thumbs down'" approach to valuing speculative investments).

The Tax Court has also rejected the use of subjective appraisal evidence. In *Abramson v. Commisioner*, 86 T.C. 360 (1980), which concerned a partnership's investment in a motion picture, the Tax Court held that it was impermissible to consider subjective appraisal evidence in evaluating the purchase price: "[R]espondent's appraisers were far from impressive. They gave every indication that they were simply performing by rote, in a biased fashion, the task for which they had been employed. *In addition, at least one of the appraisers obviously allowed his personal distaste for [the motion picture] to override his objectivity.*" 86 T.C. at 372 n. 16. (emphasis added).

The Second Circuit here was not "troubled by the fact that each of the appraisers' evaluations may contain an irreducible subjective element." 989 F.2d at 1299; (A16). The court held that this highly subjective appraisal evidence could properly be considered by the jury without prejudicing Petitioners because Petitioners had "ample opportunity during cross-examination to explore any subjective considerations underlying the experts' appraisals and to cast doubt on the reliability of those appraisals, [were] . . . free to argue to the jury that the appraisers' valuations were inherently unreliable because of subjective considerations," and because "[t]he jury, adequately instructed on the weight to accord expert testimony, was thus in a position to balance the competing opinions and to determine the actual values of the Properties on an informed basis." *Id.* at 1299-1300; (A17).

Rules 401 and 702, Fed. R. Evid., however, require that the courts assume a more active gatekeeping function with respect to expert evidence than the Second Circuit adopted in this case. As one court has aptly put it:

> As with any other kind of evidence, Rule 401 could be ignored in favor of reliance upon the enlightening effects of cross-examination; the courtroom could become a true "marketplace of ideas" where no statement of fact would be too absurd not to have its day in court. It is plain that a court would prolong trials, confuse the trier of fact and invite unprincipled results if it ignored the fundamental judicial function of screening evidence that does not meet the threshold test of raising a reasonable probability of a fact.

Porter v. Whitehall Labs., Inc., 791 F. Supp. 1335, 1345 n. 10 (S.D. Ind. 1992). *See also In re Air Crash Disaster at New Orleans, L.A.*, 795 F.2d 1230, 1235 (5th Cir. 1986) ("We will turn to the task [of reviewing the decision to admit expert testimony] with a sharp eye, particularly in those instances, hopefully few, where the record makes evident that the decision to receive expert testimony was simply tossed off to the jury under a 'let it all in' philosophy.")

Because the evidence relied on by the government to establish that the transactions were not arm's length and that the purchase prices were inflated was incompetent and inadmissible subjective appraisal evidence, Petitioners' motions for a directed verdict and for a judgment notwithstanding the verdict should have been granted for failure of sufficient proof to permit the jury reasonably to find for the government. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 573 (2d Cir.) (setting forth standards on motion j.n.o.v.), *cert. denied*, 459 U.S. 838 (1982). At a minimum, Petitioners should have been granted a new trial free of the influence of the government's subjective appraisals.

CONCLUSION

For the foregoing reasons, Petitioners respectfully pray that the Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

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